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## **Income Tax Deductions and Credits for Public and Nonpublic Education in Minnesota**

Legislation enacted in the first special session of 1997 provided an income tax credit for public and nonpublic education-related expenses other than tuition and expanded both the size and scope of the existing income tax dependent education expense deduction. Minnesota has had a dependent education expense deduction since 1955; the U.S. Supreme Court found the deduction constitutional in 1983. Minnesota had an education tax credit for nonpublic school tuition in effect from 1971 to 1973; this earlier credit was found unconstitutional by the Minnesota Supreme Court in 1974. This information brief outlines the legislative and legal history of the deduction, both the current credit and the credit in effect in the 1970s, their effects on tax liability, and education tax credit programs in three other states.

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## Executive Summary

### Dependent Education Expense Deduction

Minnesota has allowed an income tax deduction for dependent education expenses paid to others since 1955. Before the first 1997 special session, taxpayers could deduct \$1,000 for students in grades 7 to 12, and \$650 for students in grades kindergarten to 6. These limits increased to \$2,500 and \$1,625 beginning in tax year 1998.<sup>1</sup> The 1997 legislation also expanded the list of qualifying expenses, previously limited to tuition, transportation, textbooks, and instructional materials, to include tutoring, academic summer school and camps, and up to \$200 of the cost of a computer or education-related software. Beginning in 1998, taxpayers who claim the federal standard deduction have been able to claim the dependent education expense deduction. In previous years the deduction was only allowed for taxpayers who itemized at the federal level. The U.S. Supreme Court upheld Minnesota's deduction in 1983.

A deduction reduces the amount of income subject to tax; the benefit a taxpayer receives equals the taxpayer's marginal tax rate times the amount of the deduction. Most Minnesota taxpayers are in the 7.25 percent bracket, where a \$2,500 deduction decreases taxes by \$181.25.

### Education Tax Credits: 1997 and 1971-1973

Legislation enacted in the 1997 first special session provides a refundable education tax credit, beginning in tax year 1998.<sup>2</sup> The credit is limited to \$1,000 per child and \$2,000 per family. In tax year 1998, the credit was available only to families with incomes under \$33,500;<sup>3</sup> the 1999 Legislature provided for the credit to phase out for families with incomes between \$33,500 and \$37,500.<sup>4</sup> Taxpayers may claim the credit for all expenses allowed under the deduction, with the exception of nonpublic school tuition.

Minnesota allowed a refundable tax credit for nonpublic school tuition from 1971 to 1973. Pupil unit weighting made the \$100 credit worth \$50 for kindergarten students, \$100 for students in grades 1 to 6, and \$140 for students in grades 7 to 12. Because credits directly offset tax liability, a \$100 credit decreased a taxpayer's liability by \$100. In 1973, the U.S. Supreme Court struck down similar New York tax provisions, including a tuition credit. The Court found the New York credit had the effect of providing financial support to nonpublic sectarian institutions, and neither restricted the uses of public funds, nor offered ways to ensure that schools complied with

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<sup>1</sup> [Laws 1997, 1st spec. sess., ch. 4, art. 13](#)

<sup>2</sup> [Laws 1997, 1st spec. sess., ch. 4, art. 13](#)

<sup>3</sup> The income measure used is the same as for determining the property tax refund and the child care credit; it is a broad measure that includes welfare benefits, tax-exempt interest, and nontaxable Social Security.

<sup>4</sup> [Laws 1999, ch. 243, art. 2, § 14](#)

any restrictions. The Minnesota Supreme Court, following the U.S. Supreme Court decision, struck down the Minnesota credit in 1974.

Table 1 shows the number of taxpayers claiming the deduction and the estimated cost before the 1997 changes. It also shows estimates of the cost of expanding the deduction and implementing the new education credit (changes made during the 1997 first special session) and the actual cost of the credit in tax year 1998.<sup>5</sup>

Table 1  
**Fiscal Impact of Dependent Education Expense Deduction and Education Credit  
Tax Year 1998**

	<b>Cost (millions)</b>	<b>Number of Taxpayers Affected</b>
Deduction, before 1997 expansion	\$3.8	73,000
Deduction, including 1997 expansion (estimate from 1997 special session)	\$14.5	200,000
Credit (estimate from 1997 special session)	\$38.5	192,500
Credit (actual)	\$13.0	36,000

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## Dependent Education Deduction

### Description

**Minnesota allows a deduction<sup>6</sup> for education-related expenses of up to \$2,500 for each dependent in grades 7 to 12, and up to \$1,625 for each dependent in grades K-6; these**

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<sup>5</sup> The actual cost of expanding the deduction in 1998 is not available at this time. Because the deduction is reported on form M-1M rather than form M-1, it is not included in the processing file of Minnesota returns. An estimate of the actual cost of the deduction will be available when a sample of 1998 returns, including information from form M-1M, is drawn and coded in late 1999 and early 2000.

<sup>6</sup> A deduction reduces tax liability by an amount equal to the taxpayer's marginal tax rate times the amount of the deduction. The greatest tax reduction possible for the maximum \$2,500 deduction is \$200, which goes to higher income taxpayers in the 8 percent bracket. Taxpayers in the 5.5 percent bracket receive a tax decrease of \$137.50 for a \$2,500 deduction. Those with no tax liability receive no benefit from a deduction. The tax rate reductions enacted in the 1999 session effectively reduce the maximum value of the deduction.

**dollar limits increased from \$1,000 and \$650 in 1998.**<sup>7</sup> When first enacted in 1955, the deduction was limited to \$200 per dependent, regardless of grade.<sup>8</sup> The accompanying box shows the history of the deduction.

The deduction applies to:

- ▶ tuition
- ▶ textbooks
- ▶ transportation

**Tuition.** The 1997 legislation allowed deduction of the cost of more types of nonclassroom instruction, such as tutoring or academic summer school and camps. To qualify, this instruction must help to improve knowledge of core curriculum areas or expand knowledge under the graduation rule.

**Textbooks.** Textbooks include instructional materials and equipment. The law excludes books and materials used to teach religious tenets, doctrines, and worship. The 1997 legislation added computers and education-related software to the definition. However, only \$200 per year per family may be deducted for computer equipment and software.

**Transportation.** This includes the cost of transporting children to school during the regular school year, but not to summer school or camps.

Extracurricular activities, such as sporting events, music, and drama and speech activities, do not qualify.

#### Timeline: Dependent Education Expense Deduction

1955*	\$200 per dependent, for tuition and transportation expenses paid to others
1975	Amount increased to \$500 for grades K-6 and \$700 for dependents in grades 7-12. Deduction allowed for nonreligious textbooks, instructional materials, and equipment
1978	Deduction not allowed for extracurricular activities  Federal district court in Minnesota upholds deduction in <i>Minnesota Civil Liberties Union v. Roemer</i> **
1983	U.S. Supreme Court upholds deduction in <i>Mueller v. Allen</i> ***
1985	Amount increased to \$650 for grades K-6 and \$1,000 for grades 7-12
1998	Amount increased to \$1,625 for grades K-6 and \$2,500 for grades 7-12. Deduction allowed for tutoring, academic summer school and camp, and computers

\*Years shown are effective years

\*\* 452 F. Supp. 1316 (D. Minn. 1978)

\*\*\* 463 U.S. 388 (1983)

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<sup>7</sup> [Laws 1997, first special session, chapter 4, article 13](#), made the expanded deduction contingent on adequate revenue being available in the November 1997 economic forecast for the expanded deduction, the new education credit, and the increase in the working family credit. Adequate revenue was available so the three programs took effect in tax year 1998.

<sup>8</sup> Laws 1955, ch. 471, § 1

**Beginning in 1998, the deduction expanded to include tutoring, academic summer school and camps, and up to \$200 of computer hardware and educational software.** Each year the Department of Revenue provides information on what expenses qualify for the deduction. Table 2 is from the 1998 income tax instructions and gives examples of expenses that do and do not qualify for the deduction.

Table 2  
**Expenses Allowed for Dependent Education Deduction**

Expenses allowed	Expenses not allowed
Tutoring	Books and materials used for tutoring, enrichment programs, or academic camps
Tuition for academic summer camps	Sports camps or lessons
Home computer hardware and educational software	Noneducational computer software
Tuition for grades K-12 Tuition for summer school classes Fees for after-school enrichment programs Tuition for college courses that satisfy high school requirements	Tuition for nursery schools or pre-kindergarten classes Education expenses after the student has left high school
Transportation costs paid to others during the normal school day	Cost of driving children to school, tutoring, camps, or enrichment programs
Clothing required for physical education classes	Uniforms for school, including choir robes
Rental fees for musical instruments, music lessons <sup>9</sup>	
Driver's education courses if for school credit	
Nonreligious academic books and materials	Class trips Student exchange programs
Items required for courses such as shop, home economics, and art	Expenses for after-school activities, such as sports, music, and drama
Source: Instructions for 1998 Form M-1, the standard Minnesota income tax form, Minnesota Department of Revenue	

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<sup>9</sup> 1999 legislation expanded this to include tuition paid to music teachers. Under prior law, a music teacher was required to hold a baccalaureate degree in order for music lessons to qualify for the credit and deduction. Beginning in tax year 1999 the credit and deduction will also be allowed for instruction from teachers who are members of the Minnesota Music Teachers Association.

**Beginning in 1998, taxpayers are not required to claim itemized deductions at the federal level in order to claim the dependent education expense deduction.** Taxpayers may claim either a standard deduction amount, which is indexed annually for inflation, or the sum of a list of itemized deductions, whichever benefits them most. For tax year 1998, the standard deduction amount was \$7,100 for a married couple filing a joint return.<sup>10</sup> In 2000, over 300,000 taxpayers, about 45 percent of all taxpayers with dependents, are projected to use the standard deduction and will be eligible to claim the dependent education expense deduction.

When the deduction was enacted in 1955, Minnesota's income tax was not as closely tied to the federal income tax as it is today. For many years Minnesota allowed taxpayers to claim either a state standard deduction amount or state itemized deductions. The dependent education expense deduction was allowed as a state deduction, but was not allowed for taxpayers who claimed the Minnesota standard deduction amount. In the 1987 legislative session, Minnesota responded to the federal tax reform act of 1986 by conforming to the federal definition of income after deductions, but continued to allow the dependent education expense deduction in addition to itemized deductions allowed at the federal level.

**The annual cost of the deduction was projected to increase from \$3.8 million to \$14.5 million under the 1997 legislation.** Without the expanded deduction, the Department of Revenue estimated that 73,000 taxpayers would claim the deduction in 1998, at a cost of \$3.8 million in decreased tax collections. Expanding the deduction to include tutoring, academic summer schools and camps, and computers, combined with removing the requirement that taxpayers itemize at the federal level, was estimated to result in about 200,000 additional families claiming the deduction, at an average benefit of \$185 for nonpublic school parents, and \$35 for public school parents.<sup>11</sup>

## **Effect on Tax Liability**

**The tax reduction a taxpayer sees from claiming the deduction depends on the taxpayer's income and the total amount deducted.**<sup>12</sup> The value of an income tax deduction equals the taxpayer's marginal income tax rate times the amount of the deduction. Minnesota has a progressive rate structure, with higher marginal rates for higher income taxpayers. Table 3 shows the income ranges, or brackets, and tax rates for tax year 1999 by filing status. The income

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<sup>10</sup> Taxpayers who own their homes are more likely to itemize than those who rent, since deductions are allowed for property taxes and mortgage interest paid. Other itemized deductions include medical expenses and casualty/theft losses that exceed a percentage of income, state income taxes, charitable contributions, and certain business-related expenses.

<sup>11</sup> Information on the cost of the deduction based on actual 1998 income tax returns will not be available until 1999. See also footnote 5.

<sup>12</sup> For more information on tax deductions, see the House Research Department publication "Income Tax Terms: Deductions and Credits," December 1996.

ranges shown are Minnesota taxable income, which equals income after federal deductions and exemptions, and after Minnesota additions and subtractions. Taxable income is significantly lower than gross income. For example, in tax year 1999 a typical married couple with two dependents must have at least \$18,200 in gross income before having any taxable income. Table 3 takes into account the tax rate reductions enacted in the 1999 legislative session.

Table 3  
**Income Tax Rates and Brackets for Tax Year 1999**

Filing Status	5.5 percent	7.25 percent	8 percent
Married joint*	\$0 to \$25,220	\$25,221 to \$100,200	over \$100,200
Single	0 to 17,250	71,251 to 56,680	over 56,680
Head of household**	0 to 21,240	21,241 to 85,350	over 85,350
*Brackets for married separate filers are half the brackets for married joint filers. **Head of household filers are typically single parents.			

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Tax deductions under a progressive income tax provide greater benefits to taxpayers in higher tax brackets than to those in lower tax brackets, and no benefits to taxpayers who do not have taxable income. A taxpayer who claims a \$1,000 deduction and whose top tax bracket is 5.5 percent will see a tax decrease of \$55, or 5.5 percent of \$1,000. If the taxpayer's income is high enough to reach the 8 percent bracket, the tax decrease will be \$80.<sup>13</sup> If the taxpayer's income is low enough to be totally offset by the standard deduction and exemptions (\$18,200 for a family of four in 1999), a deduction provides no benefit at all.

## Legal History

Minnesota taxpayers challenged the constitutionality of the dependent education expense deduction in *Mueller v. Allen* in 1983.<sup>14</sup> The taxpayers claimed that the deduction amounted to

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<sup>13</sup> Until tax year 1998, the deduction was available only to taxpayers who claim itemized deductions at the federal level. Beginning in tax year 1998, taxpayers who claim the standard deduction are also allowed to claim the dependent education expense deduction; however, many of those claiming the deduction will be itemizers. For itemizers, the tax decrease realized at the state level is offset in part in the following year by a tax increase at the federal level. This is because itemizers also deduct state income taxes. When the education deduction reduces state income taxes, federal taxes rise. Taxpayers who receive refunds because of the deduction must add back any current year state tax refunds in determining their federal taxable income for the following tax year. The amount of the federal offset will equal the tax value of the state deduction, multiplied by the taxpayer's federal marginal tax rate. Federal marginal rates range from 15 percent to 39.6 percent, depending on income.

<sup>14</sup> 463 U.S. 388 (1983). The tax deduction statute was first challenged in *Minnesota Civil Liberties Union v. Roemer* in 1978. The federal district court in Minnesota upheld the statute because it was designed to benefit public and nonpublic school children.

an establishment of religion in violation of the First Amendment because almost all of the taxpayers using the deduction had children in parochial schools.<sup>15</sup> They argued that this fact, in addition to the fact that Minnesota public schools were largely tuition free to most residents, showed that the statute advanced religion by providing tax relief for tuition expenditures for religiously affiliated education.

**The U.S. Supreme Court, in a five-to-four decision, upheld the Minnesota statute giving tax deductions to parents for tuition and other costs they incurred in educating their children at public and nonpublic schools.**

The Court's majority found that the deduction met all three parts of the *Lemon* test (see box to right).<sup>16</sup> Justice Marshall dissented, arguing that the tuition deduction had the effect of advancing religion.

The Court found several valid secular purposes for the law under the first part of the *Lemon* test. First, by offsetting parents' educational expenses the deduction helped ensure an educated populace and protected the community's political and economic health. Second, ensuring the continued financial health of private schools helped relieve the financial burden on public schools. The Court wrote that any statutory benefit sectarian schools received could be seen as a "rough return" for the benefits these schools conferred upon the state and its taxpayers. Third, promoting "wholesome competition" between public and nonpublic schools promoted the state's interest in providing all children with the highest quality education.

Under the three-part test the U.S. Supreme Court announced in *Lemon v. Kurtzman*, 403 U.S. 602 (1971), a government action violates the First Amendment establishment clause, which forbids laws that establish religion, if it:

- (1) has a nonsecular purpose;
- (2) has a primary effect of advancing religion; or
- (3) creates excessive church-state entanglement.

The Supreme Court looked at several important features of the deduction statute in deciding whether it had the primary effect of advancing the sectarian aims of nonpublic schools under the second part of the *Lemon* test. The court appeared to consider relevant the following factors in

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<sup>15</sup> The plaintiffs showed that more than 95 percent of Minnesota's 91,000 nonpublic school students attended parochial schools during the 1979-1980 school year. Plaintiffs also showed that while the 87,000 parochial school students represented about 10 percent of the state's total elementary and secondary school population, 71 percent of the \$2,400,000 state revenue lost through the tuition deduction was due to taxpayers with children in parochial schools. 820,000 students attended the state's public schools at the time.

<sup>16</sup> Some Supreme Court justices have questioned the *Lemon* test and suggested alternative establishment clause tests, including a coercion test and an endorsement test. In *Lee v. Weisman*, 112 S.Ct. 2649 (1992), the U.S. Supreme Court held that a nonsectarian prayer at a public school graduation ceremony violated the establishment clause by coercing students to participate in the prayer. The majority opinion defined coercion to include social and psychological pressure. The dissent defined coercion as that which is supported by the force of law. In *Lynch v. Donnelly*, 465 U.S. 668 (1984), Justice O'Connor suggested modifying the *Lemon* test to say that the establishment clause is violated when government endorses or disapproves of a religion. The *Lemon* test appears to still have the support of a majority of the justices.

upholding the constitutionality of the deduction:

- ▶ the deduction was one of many deductions available to Minnesota taxpayers
- ▶ the legislature had considerable discretion in making tax classifications and distinctions
- ▶ the deduction was available to parents of both public and nonpublic school children
- ▶ public funds became available only as a result of “numerous, private choices of individual parents”
- ▶ the financial benefits to parochial schools were minor

The Court found that the statute’s potential for excessive government entanglement under the third part of the *Lemon* test might come only from state officials’ need to decide whether or not a textbook qualified for the deduction.<sup>17</sup> The Court observed that the administrative involvement implicated in the statute was like the government’s involvement in other programs the Court had already approved<sup>18</sup> and that the Minnesota statute would not excessively entangle the state in religion.

**In dissent, Justice Marshall argued that the tuition deduction had the primary effect of advancing religion.** He reasoned that “any generally available financial assistance for elementary and secondary school tuition expenses mainly will further religious education because the majority of schools charging tuition are sectarian.” Marshall charged that the textbooks and instructional materials subsidized under the textbook deduction could be used to inculcate religious values and beliefs, since the statute permitted a deduction for books the parochial schools chose. He found the majority’s opinion “flatly at odds with the fundamental principle that a state may provide no financial support whatsoever to promote religion.” He wrote that the statute provided no effective means for restricting state aid to the secular functions of private schools.

## Education Tax Credit

### Description of the Current Education Credit

**Minnesota enacted an education tax credit in the first special session of 1997**, with the credit first available in tax year 1998. Parents can claim the credit for all education-related expenses that qualify for the dependent education expense deduction, except nonpublic school tuition. Thus, the credit is allowed for transportation, tuition for academic summer school and summer camps, tutoring, and textbooks, defined to include instructional materials and equipment, including up to \$200 per family of computer hardware and educational software.

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<sup>17</sup> Instructional books and materials used in teaching religious tenets, doctrines, or worship do not qualify for a deduction.

<sup>18</sup> The Supreme Court had already authorized the government to loan textbooks to public and private school students.

The maximum credit is \$1,000 per child and \$2,000 per family. The credit is refundable. Any amount that exceeds tax liability is paid to the claimant as a refund. In tax year 1998, only claimants with incomes under \$33,500 could claim the credit. The 1999 Legislature provided for the credit to phase out for taxpayers with incomes between \$33,500 and \$37,500. The \$1,000 maximum per child phase out at a rate of \$1 for each \$4 of income over \$33,500, and the \$2,000 maximum per family at a rate of \$2 for each \$4 of income over \$33,500. The income measure used to determine eligibility for the credit is a broad measure that includes nontaxable interest, Social Security, and public welfare benefits; the same income measure is used under the property tax refund and the dependent care credit.

**An estimated 36,000 families claimed the education credit in tax year 1998, at an estimated average benefit of \$365 each, for a total cost of \$13 million.** The total cost and number of families claiming the credit is substantially lower than the Department of Revenue's estimate of a \$38.5 million cost with 192,500 families claiming the credit. The average amount claimed per return, \$365, is higher than the department's expected average of \$200 per family. The number of families claiming the credit is expected to increase as taxpayers become more familiar with the credit's availability.

## **Effect on Tax Liability of the Current Education Credit**

**Tax credits directly offset tax liability, unlike deductions, which reduce taxable income.** In the case of refundable credits, the benefit to the taxpayer exactly equals the amount of the credit claimed. If a refundable credit exceeds a taxpayer's income tax liability, the excess is refunded to the taxpayer. This is accomplished by providing an open appropriation to the Commissioner of Revenue to pay refunds allowed under the credit.

**A refundable credit provides the same benefit to all claimants, regardless of income.** As a result, filers who claim an education tax credit of \$1,000 receive a \$1,000 benefit. For those with tax liability, the benefit comes in the form of reduced taxes. Filers without tax liability receive a \$1,000 refund check.

Taxpayers may not claim the deduction and credit for the same expenses. Parents who qualify for both the deduction and credit will receive the greatest benefit by first claiming up to the maximum allowable under the credit, and then claiming any remaining expenses under the deduction. Table 4 shows how the deduction and credit interact for a married couple with two children who purchased a \$1,000 computer and had \$500 of tutoring expenses.

Table 4  
**Education Deduction and Credit Example**  
**Married Couple with Two Children**

Gross Income	\$25,000
Taxable Income	\$7,500
Education-related expenses	\$500 for tutoring \$1,000 for computer
Tax deduction	\$200 for computer
Tax decrease from deduction	<b>\$11</b> ( <b>\$200 x 5.5% tax rate</b> )
Tax credit	\$500 for tutoring \$200 for computer
Tax decrease from credit	<b>\$700</b>
Total tax decrease	<b>\$711</b>

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Claimants are limited to \$200 in computer-related expenses for both the deduction and the credit. Because this couple has \$1,000 of computer expenses, they can claim \$200 as a credit and \$200 as a deduction. Combined with their \$500 of tutoring expenses, which qualify in full for the credit, the couple experiences a total tax decrease of \$711.

## Description of the 1971-1973 Education Credit

**Minnesota enacted a nonpublic education tax credit in 1971.**<sup>19</sup> The credit was allowed for “education costs,” defined to include tuition, classroom instructional fees, and textbooks. The statute uses the same language as the deduction, specifying that the credit was not allowed for purchase of textbooks used in the teaching of religious tenets, doctrines, or worship.

The credit was set at \$100 per pupil unit for 1971 and 1972. The way Minnesota weighted pupil units made the credit worth \$50 for kindergarten students, \$100 for students in grades 1 to 6, and \$140 for students in grades 7 to 12. For 1973 and following years, the credit was adjusted by the percentage growth in school foundation aid.

**Taxpayers claiming the credit had to document their eligibility.** Their income tax returns had to include nonpublic school receipts listing:

- ▶ the name and location of the nonpublic school;
- ▶ the amount paid for education costs and textbooks and the date of payment;

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<sup>19</sup> Laws 1971, ch. 944

- ▶ the grade in which the student was enrolled; and
- ▶ the student's name and name of the person who paid for tuition and textbooks.

The legislation also required taxpayers to include certification from the nonpublic school indicating:

- ▶ that the school satisfied the requirements of compulsory attendance;
- ▶ the restricted maintenance cost of education per pupil;<sup>20</sup>
- ▶ the total amount paid by the taxpayer for education costs;
- ▶ the maximum allowable tax credit for each month of enrollment;<sup>21</sup> and
- ▶ the student's name and the number of months the student was enrolled.

The tax credit was refundable, with any amount in excess of tax liability refunded to the taxpayer. In addition, there was no limit on the number of students for whom a taxpayer could claim the credit. However, only one credit could be claimed for each student, and taxpayers had to choose between claiming the credit and claiming the already existing dependent education expense deduction.

**Timeline: Education Tax Credit**  
(in effect from 1971 to 1973)

- |      |   |
|------|---|
| 1971 | \$100 per pupil unit tax credit enacted   |
| 1972 | Ramsey County District Court finds state tax credit permissible under then-existing law<br><br>Plaintiffs appeal district court judgment  |
| 1973 | Legislation restricts credit to Minnesota residents<br><br>U.S. Supreme Court finds similar New York credit unconstitutional in <i>Nyquist</i>  |
| 1974 | Minnesota Supreme Court follows precedent set in <i>Nyquist</i> and strikes down the Minnesota credit<br><br>State Department of Revenue disallows the credit for tax year 1974 and following years |
| 1980 | Repeal of credit included in Department of Revenue technical legislation  |

Department of Revenue records show that between 44,000 and 45,000 taxpayers claimed the credit in each of the three years it was available. Taxpayers claimed \$7.4 million in credits in 1971; \$8.6 million in 1972; and \$10.6 million in 1973. The average credit claimed increased from about \$170 in 1971 to about \$240 in 1973.<sup>22</sup>

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<sup>20</sup> The statute defined "restricted maintenance cost" as 80 percent of the levy portion of school expenses.

<sup>21</sup> The statute based the total claim for the credit on a ten-month school year, so that a taxpayer could claim 10 percent of the full credit amount for each month of student enrollment.

<sup>22</sup> Available data on tuition costs suggests that the increase in amount claimed per family resulted from increased tuition at nonpublic schools.

## Legal History

**In the early 1970s New York state provided programs to children similar to the Minnesota tax credit.** The programs provided partial tuition reimbursement and tax credits to low-income parents who sent their children to nonpublic schools, including sectarian schools, by:

- ▶ reimbursing low-income parents for private school tuition,<sup>23</sup> and
- ▶ allowing a private school tuition deduction for parents who were not entitled to the tuition reimbursement.<sup>24</sup>

A third program provided direct money grants to private schools for maintaining and repairing school facilities and equipment. New York taxpayers challenged the constitutionality of the programs.

**In the 1973 case *Committee for Public Education and Religious Liberty v. Nyquist*<sup>25</sup> the U.S. Supreme Court found that New York's tuition reimbursement and tax deduction programs violated the establishment clause of the First Amendment.** The state argued that the tax programs removed the state's ability to directly fund nonpublic schools because it was only through parents' individual choices, and not state action, that state money flowed to nonpublic schools. The Court rejected the argument, finding that the programs advanced religion because the programs neither restricted the uses of public funds to nonsectarian programs, nor offered ways to ensure that schools complied with any restrictions. The Court indicated that parental choice was just one of many factors in deciding whether state funds had the effect of promoting religion.<sup>26</sup>

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<sup>23</sup> The New York tuition reimbursement statute allowed a parent who had an annual taxable income of less than \$5,000 to receive a tuition reimbursement of up to \$50 for each elementary school child and up to \$100 for each secondary school child.

<sup>24</sup> The New York tax deduction statute allowed taxpayers who had dependent children attending nonpublic elementary or secondary school to subtract from their gross income a defined amount for up to three children. The amount that taxpayers could subtract was based on taxpayers' income and not actual tuition expenses. For example, if a taxpayer's income was less than \$9,000, he or she could subtract \$1,000; once income reached \$15,000, the deduction decreased to \$400; and once income reached \$25,000 or more, no deduction was allowed.

<sup>25</sup> [413 U.S. 756](#) (1973)

<sup>26</sup> The Court has permitted aid to parents with parochial school children in those instances where there was no threat that the funds could be used for sectarian purposes. For example, in [Everson v. Board of Education, 330 U.S. 1](#), (1946), the Court upheld a New Jersey statute permitting parochial school children to use state-funded buses to reach their schools safely. In [Board of Education v. Allen, 392 U.S. 236](#) (1968), the Court upheld a New York statute that lent secular textbooks to children in public and private school. In such cases, state benefits had no sectarian characteristics and could not be put to nonsecular uses.

**In a six-to-three<sup>27</sup> decision, the Court found that all three programs had the effect of promoting religion and were unconstitutional under the second part of the *Lemon* test.<sup>28</sup>**

The Court held that the effect of the tuition reimbursement was “unmistakably to provide financial support for nonpublic sectarian institutions” because the payments gave parents a financial incentive to send their children to religious schools and the financial ability to do so. The Court struck down the tax deduction because it rewarded parents for sending their children to nonpublic schools and operated, in effect, as a tax credit by allowing a fixed amount of “tax forgiveness” to those parents who did what the state encouraged without regard to the taxpayer’s actual tuition expenses.<sup>29</sup> The Court used a similar analysis for the program directing money grants to private schools for maintenance and repairs, concluding that the state could not ensure that direct money grants to private schools went for secular purposes.<sup>30</sup>

**In 1974, following the *Nyquist* ruling, the Minnesota Supreme Court found Minnesota’s tax credit unconstitutional in *Minnesota Civil Liberties Union v. State*.<sup>31</sup>** In 1971, the Minnesota Civil Liberties Union, Americans United for Separation of Church and State, and seven Minnesota taxpayers challenged the Minnesota tax credit on the grounds that it violated the U.S. Constitution and the Minnesota Constitution. In 1972, before *Nyquist* was decided, the trial court found the statute to be constitutional. The trial court reasoned that the statute had a valid secular purpose, that it survived entanglement challenges, and that the primary effect of the statute was not to promote the establishment of religion. The plaintiffs appealed to the Minnesota Supreme Court.

While the appeal was pending, the U.S. Supreme Court announced a series of decisions, including *Committee for Public Education v. Nyquist*, that, according to the Minnesota Supreme Court, “effectively changed the course and standard of measurement of establishment questions.” The state supreme court discussed the *Nyquist* opinion at length and declared its intent to follow the precedent set in *Nyquist* in evaluating the tax credit statute before it. In applying the three-part *Lemon* test, the court had no difficulty in finding a secular purpose for the statute. The court found the “primary effects” part of the test problematic because it believed that the result in *Nyquist* obligated it to use an “any effects” test instead. Under such a standard, where the First

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<sup>27</sup> Chief Justice Burger and Justice Rehnquist both dissented in part, and Justice White dissented from the entire opinion.

<sup>28</sup> The Court concluded that the statutes had a secular purpose, which satisfied the first part of the *Lemon* test, and stated in dicta that it was unlikely the statutes would pass the excessive entanglement test, the third part of the *Lemon* test.

<sup>29</sup> The Court reserved its right to decide the constitutionality of a genuine tax deduction.

<sup>30</sup> The statute limited grants to nonpublic schools to 50 percent of the amount expended for comparable services in public schools. The Court observed that “a mere statistical judgment will not suffice as a guarantee that state funds will not be used to finance religious education.”

<sup>31</sup> 302 Minn. 216, 224 N.W.2d 344 (1974), *cert. denied*, 421 U.S. 988 (1975)

Amendment establishment clause received clear preference over the free exercise clause,<sup>32</sup> the court found that the tax credit statute could not pass constitutional muster under federal law.<sup>33</sup> The court rejected the argument that Minnesota's tax credit statute could be distinguished from *Nyquist*.

**Taxpayers were allowed to keep credits issued from 1971 to 1973.** The court did not consider the constitutionality of 1974 state legislation that prohibited the Commissioner of Revenue from recovering credits paid in previous years.<sup>34</sup> The credit was not allowed for 1974 and following years because it was found unconstitutional before the end of the 1974 tax year. The tax credit remained in statute until 1980, when it was repealed in a Department of Revenue technical bill.

## Other States' Programs

Arizona, Illinois, and Iowa also provide income tax credits for education-related expenses. Courts have ruled on the permissibility of the Arizona and Iowa credits.

### Arizona

Arizona provides its taxpayers with two education-related credit programs: a \$500 tax credit for contributions to school tuition organizations that operate like charities; and a \$200 tax credit for extracurricular public school fees. Both credits may be carried forward for up to five tax years if the credit exceeds the taxpayer's liability.

**Credit for contributions to school tuition organizations.** Arizona taxpayers may claim a credit of up to \$500 for contributions to school tuition organizations that assist students with the cost of tuition at a qualified school. Arizona statute, section 43-1089, paragraph E, defines "qualified school" as a nongovernmental primary or secondary school in Arizona that does not discriminate on the basis of race, color, handicap, familial status, or national origin and that satisfies state requirements for private schools; this definition allows schools to limit admission based on religious adherence, preference, or observance. The same paragraph defines "school tuition organization" as a section 501(c)(3) charitable organization that allocates at least 90 percent of its

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<sup>32</sup> The establishment clause forbids laws that establish religion, and the free exercise clause forbids laws that prohibit the free exercise of religion.

<sup>33</sup> Although the Minnesota Supreme Court disposed of the constitutional challenge on federal constitutional grounds, it specifically commented on the validity of the statute in the context of the state constitution. The court quoted those sections of the state constitution providing for "a thorough and efficient system of public schools" and prohibiting the use of public moneys for the support of religious schools. The court also commented upon the failure of the courts and the litigants in the case to recognize that the major problem at issue was "society's concern for the children involved."

<sup>34</sup> Laws 1974, ch. 556, § 20

annual revenue for educational scholarships or tuition grants to children to allow them to attend any qualified school of their parents' choice.

Under this tax credit law, parents may not designate the credit to benefit their own children and nonprofit organizations may not designate the credit to benefit students of only one school. If a taxpayer's allowable tax credit for a given year exceeds the taxes due, the taxpayer may carry the credit forward for up to five years.

In tax year 1998 over 4,000 Arizona filers claimed the school tuition credit. By checking these claims against information provided by school tuition organizations the Arizona Department of Revenue found just over 2,000 of the claims to be valid, for about \$900,000 of credits and an additional \$25,000 carried forward.

**Credit for extracurricular public school fees.** Arizona taxpayers may claim a credit of up to \$200 per family for any fees the taxpayer pays for extracurricular activities at a public school. Under Arizona section 43-1089.01, "extracurricular activities" means the equipment, uniforms, and materials that students must have in order to participate in school-sponsored activities and for which a fee is charged. If a taxpayer's allowable tax credit for a given year exceeds the taxes due, the taxpayer may carry the credit for up to five years. Schools must charge extracurricular fees if taxpayers are to participate in the tax credit program.

In tax year 1998 over 33,000 Arizona filers claimed the extracurricular activity fee credit. Through June 1999 the Arizona Department of Revenue had reviewed 13,000 claims and found 11,000 to be valid, for a total of about \$2.0 million of credits claimed and about \$44,000 carried forward. If the percentage of returns found to be valid remains constant through all 33,000 returns, the total cost will be about \$6 million.

**Legal challenge.** When the Arizona Legislature enacted both the tax credits in 1997, state taxpayers and education groups filed a lawsuit in the Arizona Supreme Court, rather than a trial court, to gain an expedited ruling on whether the credit for school tuition organization contributions, which benefits students attending private religious schools, violates federal and state constitutional prohibitions against government aid to religion. According to critics, the law does not:

- ▶ require school tuition organizations to give priority to poor children when granting scholarships
- ▶ cap scholarship amounts in order to benefit the maximum number of students
- ▶ explicitly prevent taxpayers from designating their contributions to benefit specific students who are not their own children
- ▶ preclude nonprofit groups from targeting donors interested in supporting scholarships to specific schools such as evangelical Christian schools.

In a three-to-two decision, the court upheld the law, concluding that the tuition tax credit does not prefer one religion over another, aids a broad spectrum of citizens, allows a wide range of

private choices, and does not have the effect of advancing or inhibiting religion. The court based its conclusions on a variety of factors, including the following:

- ▶ there are no constitutionally significant distinctions between credits and deductions
- ▶ the school tuition tax credit is only one of an extensive assortment of tax saving mechanisms available to all state taxpayers, and not just to parents of school children
- ▶ student tuition organizations may not limit grants to students of only one institution
- ▶ the tax credit law achieves a higher degree of parity among families by making private schools more accessible and providing alternatives to public education
- ▶ the primary beneficiaries of the credit are taxpayers who contribute to student tuition organizations, whereas private religious schools are only incidental beneficiaries
- ▶ the tax credit is not an appropriation of public money and no money ever enters the state's control as a result of this credit

The two dissenting judges vigorously disagreed with the majority, arguing that the school tuition organization contribution credit represented government action designed to induce taxpayers to give direct financial support to predominantly religious schools, thereby violating both federal and state constitutional prohibitions against government aid to religion. The dissent observed that the law did not offer the same or even similar benefits to all taxpayers; it provides a \$500 credit for private school tuition contributions and a \$200 credit for reimbursement of extracurricular activity fees charged at public schools. The dissent also was troubled by the ability of a group of taxpayers under the law to form a school tuition organization to support schools affiliated with a particular religion. This decision is legally binding only in Arizona unless the U.S. Supreme Court overturns the decision on appeal.

## Illinois

Illinois enacted legislation in June 1999 to provide its taxpayers with a tax credit of up to \$500 per family for qualified educational expenses for tuition, books, and lab fees. The credit equals 25 percent of qualified educational expenses above \$250, up to the maximum of \$500; a family must spend at least \$2,250 to qualify for the full \$500 credit. The credit is nonrefundable; that is, taxpayers' liability cannot be reduced to less than zero under this credit. To be eligible for the credit, the student generating the qualified educational expenses must be

- ▶ an Illinois resident,
- ▶ under age 21 at the end of the school year for which the taxpayer claims the credit, and
- ▶ enrolled full-time in a kindergarten through grade 12 education program at any public or accredited nondiscriminatory nonpublic school that provides instruction in English.

**Legal challenge.** The \$250 threshold makes most families of public school children ineligible for the credit. The Illinois Federation of Teachers has pending a lawsuit in a state circuit court challenging the constitutionality of the tax credit under clauses in the Illinois Constitution providing for religious freedom and forbidding the use of public funds for sectarian purposes.

## Iowa

Iowa provides its taxpayers with a tuition tax credit equal to 25 percent of the first \$1,000 the taxpayer pays to others for tuition, nonreligious textbooks, and extracurricular activities for each dependent in kindergarten through grade 12 who attends an accredited not-for-profit nondiscriminatory elementary or secondary school in Iowa. The credit percentage was increased from 10 percent to 25 percent in tax year 1998. Under Iowa Statute, section 422.12, subsection 2, “textbook” means books and other instructional materials and equipment used in teaching subjects commonly taught in the state’s public elementary and secondary schools. The definition of “textbook” excludes religious textbooks and materials. Beginning in 1998, the definition was amended to include books and materials used for extracurricular activities such as sporting events, musical or dramatic events, speech activities, driver’s education, and similar programs; these books and materials were excluded before 1998. The same subsection defines “tuition” to mean charges for personnel, buildings, equipment, materials, and other expenses of elementary and secondary schools related to teaching subjects commonly taught in the state’s public elementary and secondary schools. The definition of “tuition” excludes charges related to teaching religious subjects. The definition of “tuition” was expanded beginning in tax year 1998 to include charges for providing extracurricular activities; before 1998 charges for extracurricular activities were explicitly excluded from “tuition.” There is no income limit on eligibility for the credit; before 1998 the credit was limited to taxpayers with household incomes under \$40,000.

In tax year 1997, when the credit was still at 10 percent of the first \$1,000 of expenses, and when the definition of expenses excluded books, materials, and charges for extracurricular activities, about 89,000 taxpayers claimed the credit for a total tax expenditure of about \$3 million. In tax year 1998, after the credit rate increased to 25 percent, the definition of allowable expenses was expanded to include extracurricular activities, and the household income limit was removed, the number of taxpayers claiming the credit increased to 71,500, for a total tax expenditure of \$8.7 million.

**Legal challenge.** The Iowa Legislature first enacted legislation providing taxpayers with tuition and textbook deductions or credits on personal income tax returns in 1987. Iowa taxpayers brought suit in federal district court claiming that the income tax law violated the establishment clause to the First Amendment of the U.S. Constitution that prohibits Congress and the states, through the Fourteenth Amendment, from making laws establishing religion. The federal district court determined that the case was substantially similar to *Mueller v. Allen*, in which the U.S. Supreme Court upheld the constitutionality of Minnesota’s education tax deduction statute. The court in *Luthens v. Bair* found the Iowa tax law constitutional because, among other things, it:

- ▶ assured that taxpayers using the standard deduction gained the same type of tax benefit based on actual tuition and textbook payments that itemizing taxpayers gained
- ▶ encouraged students to attend accredited schools, which served an important state interest
- ▶ provided direct financial benefits to the parents of school children, and only attenuated benefits to schools
- ▶ excluded expenses related to the teaching of religion

- ▶ avoided the need for on-site monitoring by prorating the financial benefit based on the time a student spent in classes for religious instruction and for subjects commonly taught in public schools
- ▶ created a relationship between the state and its taxpayers and, because it did not provide any kind of direct aid to parochial schools, did not create an impermissible relationship between the state and parochial schools.

In 1999, legislatures in Colorado, Maine, Maryland, Montana, Nebraska, and North Dakota considered but did not enact bills containing education tax credit proposals.

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